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Are Big U.S. Banks Big Enough?

According to some observers, international banking is like sumo wrestling—in one respect, at least: An institution needs to be big to compete and, generally, bigger is better. The analogy is motivated by the prominence of Japanese banks among the world's largest banks. A decade ago, the U.S. had the two largest banking organizations in the world (by asset size), and only one Japanese bank ranked among the top ten. But today, the list of the ten biggest banking organizations includes eight Japanese banks and no U.S. banks.

This apparent reversal of fortune has been used to support the argument that U.S. banks are not big enough to compete internationally. To some extent the fuel for this argument has diminished as the fall in the Japanese stock market and problem domestic and foreign loans have dulled the luster of Japanese banks' performance. Nevertheless, the presence of foreign "mega"-banks is still seen as a mandate for bigger banks in the U.S. This *Weekly Letter* looks at this issue by considering the evidence on the importance of bank size to efficiency and international competition.

Banking structure

The U.S. banking system is less concentrated than the banking systems of many other countries. In part this is due to the U.S.'s historical restriction on banks' geographic expansion. Over the past decade, however, these legal barriers to bank consolidation have been relaxed. For example, since 1983, the number of states permitting statewide branching increased from 23 to 38, while the number of limited branching states declined from 19 to 11 and the number of unit banking states fell from 8 to 1. In addition, all but three states now have enacted legislation that permits entry by certain out-of-state banks, with most states allowing entry from any state. As a result, since 1980, the number of commercial banking organizations—that is, holding companies plus independent banks—has fallen from about 12,700 to 9,700, a 24 percent drop.

Even with these changes, however, the number of banks in the U.S. remains high relative to other countries. Currently the U.S. has about forty commercial banking organizations per million people, while the United Kingdom has around ten per million, and Japan has a little more than one per million.

Further consolidation in the U.S. banking system will occur, since the banking industry is still adjusting to the changes in the regulatory environment. But it is not likely that the U.S. banking system will become as concentrated as the ones in many other countries, both because of residual limitations on geographic expansion and because of the greater emphasis the U.S. places on the anticompetitive effects of bank mergers. Although in recent years regulators have approved more bank mergers in light of increased nonbank competition, they will continue to keep antitrust considerations in the forefront.

Some are concerned that these regulations obstruct the economic forces that would "naturally" give rise to "mega"-banks here in the U.S. In particular, they argue that restrictions on consolidation, particularly for large banks, sacrifice efficiency, which is detrimental not only to the U.S. banks' international competitiveness, but also to their domestic customers.

Size and efficiency

The empirical research on efficiency in banking raises doubts about how far the advantages of size go. Most studies on cost efficiency suggest that scale economies are exhausted well below the size of the larger U.S. banks. Moreover, recent studies find that unexploited scale economies account for a relatively small part of the overall variation in efficiency among banks. This means that, beyond a point, the efficiency gains owing to size may be small.

Bank mergers could increase efficiency in other ways, however. For example, empirical research finds that the measured degree of efficiency varies greatly among banks. One interpretation of this finding is that the variation in efficiency is due to differences in the way banks use inputs; in other words, some banks simply may be managed better than others. In that case, a successful merger would involve a more efficient firm taking over a less efficient firm.

There are, of course, other reasons for bank mergers. One is portfolio diversification through geographic expansion. The changes in intrastate and interstate banking laws mentioned above opened the way for banks to pursue that objective through mergers. The mergers that are intended to achieve diversification could be viable, even without a difference in the economic efficiency of the banks being combined.

Whatever the motivation, the empirical evidence on the effects of actual mergers suggests that, though the resulting firm may be bigger, it is not necessarily more efficient. For example, while mergers tend to reduce personnel costs per unit of output, those savings are often offset by increases in other costs. The evidence shows that some bank mergers have improved efficiency while others have decreased it, and on balance the effects have been more or less neutral.

Even though formal statistical analysis does not make much of a case for directly linking "mega"-bank size and efficiency, the structure of banking in much of Europe and Japan often is viewed as evidence that large banks have a competitive edge stemming from greater efficiency. This view would be more persuasive if the banking systems in other countries were clearly the results of banks taking advantage of economic efficiencies. However, just as regulatory policy has affected banking structure in the U.S., regulatory policies in other countries have influenced their banking structures. In several major countries, policies have limited the number of banks, which has led to relatively concentrated banking structures. The banking structures observed in these other countries, then, are not proof that big banks are generally more efficient in providing financial services.

Are big banks better international competitors?
A look at which banks are active in international banking suggests that size does matter to some extent. Around the world, large banks are generally the only ones with any meaningful global presence. In the U.S., for example, only the largest banks ($20 billion or more in assets) are materially involved in international banking. It is interesting to note that most studies find that scale economies for U.S. banks are exhausted well before that point. This suggests that it is possible that scale economies in international banking continue beyond the point where they are spent in other aspects of banking.

The advantages of size in international banking, however, do not necessarily increase indefinitely. In the U.S., many banks with over $20 billion in assets are involved to a significant extent in overseas business. Among these large banks, size does not seem to have much bearing on the degree of globalization. More specifically, among the large banks, the importance of foreign activities relative to domestic banking is not strongly related to the size of a bank. Moreover, the ability of some moderately large U.S. banks to have 50 percent or more of their activity related to international banking suggests that they can compete effectively. It is also important to note that a good deal of international banking involves off-balance-sheet items, such as options, swaps, and forward contracts. In this area, U.S. banks have been very strong competitors, which tends to belie the notion that U.S. banks are at a disadvantage owing to their size relative to larger foreign banks.

In other countries, the picture on asset size and globalization is mixed. For Japan, size is positively correlated with globalized activities. For large globally active German banks, there does not appear to be a connection between size and globalization. For Canadian and French banks, the correlation is *negative*—that is, the larger the bank, the smaller its proportion of international activity.

A look at the competition
The "mega"-banks we have been discussing so far are not purely the creatures of favorable regulatory policy, of course. The growth in assets of many large foreign banks relative to the large U.S. banks also reflects domestic economic conditions in those countries. This clearly has been the case for Japan: A rapid economic expansion, coupled with policies limiting the number of banks, fostered the growth of the large banks. It is not clear, however, that gains by a bank in its domestic market necessarily translate into greater competitiveness elsewhere in the world.

On this point, the experience of Japanese banks on our West Coast is interesting. In California, Japanese-owned banks clearly are a presence, with about 25 percent of banking assets. While Japanese banks in the state naturally have an advantage in dealing with Japanese firms involved in international trade, they do not appear to have an advantage in providing banking services more generally, nor have the Japanese banks had higher earnings. During the past ten years, Japanese banks' performance in terms of return on assets (ROA) has not been better than that of domestically owned banks, on average. In fact, over the past four years, domestically owned banks in California have had a higher ROA. And, last year, Japanese-owned banks in the state posted a net loss, while domestic banks showed positive, though modest, earnings. It is also interesting to note that, as a group, other foreign banks operating in the U.S. have underperformed domestic banks over the past several years. U.S. banks, then, certainly are not at any disadvantage in competing with foreign banks in U.S. markets.

Conclusion

Big banks in the U.S. are big enough to compete effectively with their foreign counterparts. Therefore, the relative size of banks in the U.S. compared to those in other countries should not be a determining factor in the degree of consolidation in the U.S. banking industry. Even without that influence, though, further consolidation in the U.S. banking system is inevitable. But the result should be a competitive domestic banking system with numerous banks, including small banks and several large banks that are active internationally, even if they do not match the ultra-mega status of some of their foreign competitors.

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